

BEFORE THE
POSTAL REGULATORY COMMISSION
WASHINGTON, DC 20268-0001

Review of Commission's
Price Cap Rules

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Docket No. RM2013-2

**VALPAK DIRECT MARKETING SYSTEMS, INC. AND
VALPAK DEALERS' ASSOCIATION, INC.
COMMENTS ON NOTICE OF
PROPOSED RULEMAKING
(May 16, 2013)**

On March 22, 2013, the Commission issued Order No. 1678, "Notice of Proposed Rulemaking Requesting Comments on Proposed Commission Rules for Determining and Applying the Maximum Amount of Rate Adjustments." This Order invited "comments and suggestions to clarify or improve part 3010 of the Commission's regulations. These comments may address the changes discussed in this Order, and they also may suggest additional changes." Order No. 1678, p. 12. The Order set May 16, 2013 as the deadline for comments and set May 31, 2013 as the deadline for reply comments. *See 78 Fed. Reg.* 22490 (Apr. 16, 2013). Valpak Direct Marketing Systems, Inc. and Valpak Dealers' Association, Inc. ("Valpak") jointly submit the following comments.

COMMENTS

I. Comments Supporting Certain Commission's Proposals.

A. Same Methodology for Products and Classes.

The Commission's proposed change to rule 3010.23(b) would require that the percentage changes in average prices reported by the Postal Service for **products** be based on the same methodology used for **classes**. In Docket No. R2013-1, the Postal Service devised a

different methodology for products and classes in order to show that increases for the Standard Flats product were the same percentage increase as the price cap. However, this methodology distorted and artificially inflated the percentage increase for Standard Flats, and thus was not in compliance with the Commission's FY 2010 Annual Compliance Determination ("ACD") directive. *See* Order No. 1541, pp. 48-49. The Postal Service presented the thinnest of reasons for using a different methodology. The amendment to rule 3010.23(b) should prevent this type of manipulation of data by the Postal Service in the future, and Valpak supports this proposed rule change.

B. Content of Comments.

The Commission's proposed change to rule 3010.11(c) clarifies the Commission's position that the Postal Service's failure to comply with prior Commission orders and directives is a valid topic for consideration in the context of a price adjustment docket. In Docket No. R2013-1, the Postal Service's compliance with the FY 2010 ACD directive was in question and was the basis for the Commission need to reject the Standard Mail prices and remand them for compliance. One mailer association attempted to prevent the Commission from considering whether the Postal Service prices were in compliance with prior Commission orders that it did not like. *See* Order No. 1541, p. 35. It should be obvious that the legality of proposed prices — under Congressional statutes, Commission regulations, and Commission directives — is a relevant topic of consideration in price adjustment dockets, and Valpak supports this proposed rule change.

C. NSA Reporting.

Current rule 3010.43 requires an annual data report for each year of a negotiated service agreement (“NSA”), and that includes “the change in net financial position as a result of the agreement.” Proposed rule 3010.43 clarifies that which should have been obvious to all, that the rule seeks information on the net change in financial position of the Postal Service caused by the NSA. Valpak supports this proposed rule change. (Additionally, these comments include an additional recommendation for NSAs. *See* Section IV, *infra*.)

II. Comments Urging Changes in Certain Commission Proposals.

Valpak also urges some changes to the rules proposed by Order No. 1678.

A. Temporary Promotions

Order No. 1678 states that it was proposing paragraphs 3010.23(e) and (f) to reflect the Postal Service’s past decisions “not to include temporary promotional rates and incentive programs in the calculation of percentage change in rates when those rates and programs resulted in overall rate decreases.” Order No. 1678, p. 11. It adds that paragraph (e) “states the Commission’s approval of this practice.” *Id.* However, in its “Explanation of Proposed Rules,” the Commission states that “Proposed rule 3010.23(e) allows the exclusion of temporary promotional rates and incentive programs from percentage change in rates calculations....” *Id.*, p. 15. Indeed, paragraph (e) appears to defer the matter to the Postal Service: “The Postal Service may exclude temporary promotional rates....” *Id.*, Attachment, p. 9.

Valpak’s Comments in Docket No. R2013-1 explained how the Postal Service took the principled position in Docket Nos. R2009-3, R2009-5, and R2010-3 that those promotions

should have no price cap impact. *See* Valpak Comments, pp. 42-43. In each of those three dockets, the Commission determined that the Postal Service's treatment was proper. However, in Docket No. R2011-1, the Postal Service reversed position, and attempted to get additional price cap authority from the discount promotion in that docket. The Commission rejected that effort, consistent with established practice:

Mailers that are not eligible to participate should not have negative consequences resulting from the incentive. Moreover, increasing unused rate authority could encourage the Postal Service to offer incentives that are otherwise unlikely to improve its financial condition. [Order No. 606, p. 19.]

Subsequently, the Postal Service proposed and the Commission approved temporary promotions with no price cap impact in three more dockets.¹

In Docket No. R2013-1, the Postal Service asked for discounts which increased the price cap and preserves the right to shift losses from promotional pricing onto other rates and ratepayers. After determining in seven promotions dockets that those changes had no impact on price cap, the Commission *sub silentio* reversed position and, for the first time, allowed the Postal Service to include revenue forgone from several prospective temporary pricing promotions in the cap calculation. In its order approving this change of direction, the Commission noted Valpak's objections: "Valpak urges the Commission to keep with the established practice of not allowing inclusion of revenue forgone in the price cap calculation at this time." Order No. 1541, p. 16. Despite appearing to understand Valpak's point, the Commission never again mentioned that aspect of the issue, nor explained what circumstances

¹ *See* Docket No. R2011-5, Order No. 731, p. 9; Docket No. R2012-6, Order No. 1296, p. 6; Docket No. R2012-9, Order No. 1424, p. 7.

might have changed between Docket No. R2012-9 and Docket No. R2013-1. Instead, it stated simply: “For the reasons discussed above, the Commission finds that the Postal Service’s price cap treatment of promotions is permissible so long as volumes are properly ascribed to the appropriate products.” Order No. 1541, p. 18. This reference to inadequate analysis falls far short of the Commission’s duty to “supply a reasoned analysis” when “changing its course.” *See Motor Vehicle Mfrs. Ass’n v. State Farm Mut. Auto. Ins. Co.*, 463 U.S. 29, 57 (1983).

The pending Tech Credit docket (Docket No. R2013-6) further demonstrates the inequity of including temporary promotions in the calculation of the price cap. The Postal Service proposed that mailers of several, but not all, products will be eligible for a credit for using Full-Service Intelligent Mail Barcode (“IMb”). However, much of the debate in that docket surrounds which products will see the additional increase in prices to pay for the credit. Although the Postal Service intends to offer the credit to mailers of underwater products including Standard Flats, the Postal Service has not indicated any plan to deviate from its schedule to increase Standard Flats only by 5 percent of CPI above CPI each year for three years. Thus, other profitable mailers will be hit in the future with higher increases to even further subsidize Standard Flats, a product which continues to bleed the Postal Service financially.

The Postal Service Notice in Docket No. R2013-6 appears to justify its proposal based on its interpretation that the Commission’s current rules “do not appear to address the calculation and use of its pricing authority in such a situation” (p. 4). The Postal Service believes that the Commission’s proposed regulations in this docket do “not clarify how to

assess the Technology Credit Promotion's effect on the price cap." *Id.*, p. 5. Clearly, therefore, changes must be made to the regulations as proposed.

Valpak believes the Commission should return to its established practice of not including temporary pricing promotions in the price cap calculation. This would be consistent with the ratemaking objective of "predictability and stability in rates" (39 U.S.C. § 3622(b)(2)), the objective to "reduce the administrative burden and increase the transparency of the ratemaking process" ((b)(6)), and the factor of "simplicity of structure for the entire schedule and simple, identifiable relationships between the rates or fees charged the various class of mail for postal services" ((c)(6)).

B. Workshare Discounts

The Commission cites a disagreement it had with the Postal Service in Docket No. R2013-1 with respect to a new price tier: "the Commission had reason to believe that the Postal Service's determination of what constituted a workshare discount might differ from the Commission's determination." Order No. 1678, p. 11. However, the Commission goes overboard by proposing regulations that require the Postal Service to provide the information required for workshare discounts for "all discounts and surcharges."

Clearly, the Commission has authority over workshare discounts pursuant to 39 U.S.C. § 3622(e). But this jurisdiction does not apply to all discounts, nor does section 3622(e) require the type of compliance for workshare activities outside of the four enumerated activities. The Commission's solution here is too broad to solve the workshare discount issue. Furthermore, it unnecessarily increases the "administrative burden" (§ 3622(b)(6)) of the

Postal Service by requiring certain information for new discounts that appear to be outside of the workshare discount definition.

III. Comments Pertaining to the Maximum Amount of Price Adjustment in Rate Cases before the Commission.

The Commission's Notice of Proposed Rulemaking in this docket states that "comments may address the changes discussed in this Order, and they **also may suggest additional changes.**" *Id.*, p. 12 (emphasis added). This section responds to the invitation to suggest additional changes. Broadly stated, the issue raised here is: When the conditions defined by the rules are met and either an **increase or a decrease** in the maximum price adjustment that otherwise would prevail is indicated, what data shall be used to compute the allowed deviation, above or below the CPI-based price cap?

A classic criticism of price caps is that they provide incentives that actually encourage companies to degrade the quality of service in an effort to cut costs. Effectiveness of price cap regulation is conditional upon the cap not being undermined by systematic degradation in quality of service. Most of the literature dealing with price cap regulation is based on the telecommunications industry, where price cap regulation has been widely adopted.

Discussions on using "penalties" to discourage reductions in service can be found in that literature.²

² See "Price Cap Regulation: What Have We Learned from Twenty-Five Years of Experience in the Telecommunications Industry," by David E. M. Sappington and Dennis L. Weisman. The authors state that "incentive regulation plans often stipulate service quality standards and **impose financial penalties if the standards are not met.**" p. 28 (emphasis added), http://bear.warrington.ufl.edu/centers/purc/docs/papers/1012_Sappington_Price_Cap_Regulation.pdf.

Actions to reduce service quality can be expected to reduce costs and, in the case of the Postal Service, increase contribution. Insofar as the Postal Service provides less value per dollar of revenue, a reduction in service is tantamount to a *de facto* price increase. Indeed, the Commission itself has frequently commented on the necessity of good service performance data to help assure that service performance is not systematically being diminished as a means of circumventing the price cap, a central component of the Postal Accountability and Enhancement Act (“PAEA”).

Until Commission rules state that some reductions in service, depending upon their severity or egregiousness, will be given consideration when determining the maximum price cap adjustment in any given year, the Postal Service each year will have unrestrained license to increase operating profitability by reducing the quality of service being provided to mailers and the public. Systematic reductions in service standard or actual quality of service provided, in an effort to reduce costs and increase contribution, would be in accord with abstract theoretical discussions about price cap regulation.

For example, under the price cap regulation introduced by PAEA, service reductions have occurred, as yet with no implications for the Postal Service’s price cap authority.

- The Postal Service has proposed to reduce costs by eliminating retail service in thousands of small communities through closure of the local Post Office.
- After closing a relative handful of post offices, the Postal Service halted the closure program and instead substituted a program designed to cut costs by significantly reducing the weekly hours of operation at some 13,000 post offices.
- The Postal Service has proposed to reduce costs by eliminating Saturday residential delivery nationwide.

The Commission can use this docket as an opportunity to begin addressing the important question of whether price cap regulation will provide various stakeholder groups with any protection from severe degradation in quality of service, or whether additional safeguards are needed.

In addition to issues pertaining to service quality, in Docket No. R2013-6, the Public Representative has raised another broad set of issues that point to possible consideration of **reductions** in the maximum price adjustment that otherwise would prevail (*i.e.*, the CPI-based price cap).³ Specifically, the PR states:

if the Tech Credit has price cap implications, the related change in barcode standards from POSTNET to Full-Service IMb **must also have price cap implications** that need to be taken into account. [Docket No. R2013-6, PR Comments (May 6, 2013), p. 3 (emphasis added).]

The PR's rationale would appear to be that the change in barcode requirements amounts to a *de facto* price increase and, presumably, the price cap should be **reduced** by an appropriate amount to reflect this *de facto* increase in addition to the annual rate adjustment.⁴

Stated in broader terms, the PR's point is that Postal Service changes in regulations and mailing requirements can reduce its costs while increasing costs to mailers. As an example: require more thorough address cleansing in order to continue qualifying for presort or automation discounts. Mailers who keep doing what they were doing previously and do not

³ This set of issues pertain to large set of actions that customers (*i.e.*, mailers) are required to take in order to help reduce Postal Service costs. They have no meaningful counterpart in the telecommunications industry.

⁴ The PR's Comments expand on this thought in Section V, pp. 12-15.

comply with the new regulation then are faced with a *de facto* price increase — while the price cap remains unchanged and annual price increases for mailers continue unabated. The PR cogently notes that some of the requirements imposed by the Postal Service do not affect its operations (*e.g.*, if the Postal Service changes its automation equipment in a way that requires mailers to change, it is not unreasonable to require mailers to make conforming changes in order to receive the automation discount).

As another example, in order to continue receiving automation discounts, mailers are required to use the IMb barcode in lieu of the Postnet code. Costs of converting from Postnet to IMb are paid by the mailer. Mailers who do not incur the conversion costs and continue using the Postnet code must pay the higher non-automation price as well as being faced with higher prices equal to the CPI in the next annual rate adjustment.

Continuing this example, in order to continue receiving automation discounts, mailers that have adopted the IMb barcode in lieu of the Postnet are required to submit Full-Service documentation with their mailings, or pay a higher price. Costs for converting from simple IMb to Full-Service are each mailer's responsibility. Any non-Full-Service mailing must pay the higher non-automation price as well as be faced with higher prices equal to the CPI in the next annual rate adjustment.

When the Commission crafts rules which specify conditions under which the applicable CPI price cap might be reduced, it then must face the issue of what data to use when determining the extent of such reduction. Until such conditions are specified, however, it could be premature to develop specifics concerning the relevant data.

Valpak would suggest that this would be an appropriate docket in which to give explicit consideration to Commission treatment of service reductions under a price cap regime.

IV. Recommended Changes to the Rules for Negotiated Service Agreements.

Order No. 1678 invited suggestions for changes to Part 3010 beyond those proposed by the Commission. Valpak suggests that the Commission take the opportunity presented by this docket to clarify some aspects of its rules pertaining to the required contents of a “notice of agreement” in support of an NSA found in rule 3010.42.

A. Require Use of Commission Methodology for Claimed Financial Effects.

The current rules for a proposed NSA require the “[d]etails regarding the expected improvements in the net financial position or operations of the Postal Service.” Rule 3010.42(c) (in proposed rule 3010.42(f)). Those details are to be based on mailer-specific data, if possible, and if not available, then on a suitable proxy. Valpak recommends that financial reporting on an NSA, including improvements in the net financial position, be based on the Commission’s methodology, including its choice of proxy.

Once the Commission has approved an NSA, the Postal Service’s reporting in the Annual Compliance Report (“ACR”) should be based on the methodology approved by the Commission in its Order reviewing the NSA. In the FY 2012 ACR, the Postal Service reported the results of the first year of the Discover NSA in disregard of the methodology used by the Commission in its Order so as to present an underwater NSA as being profitable. This required the Commission to issue an inquiry to obtain from the Postal Service the Year One results using Commission-approved methodology. The Commission should amend its rules to require reporting using Commission-approved methodologies.

B. Require Definition of Mailers Deemed to Be Considered Similarly Situated to a Proposed Domestic Market Dominant NSA.

39 U.S.C. § 3622(c)(10) requires, *inter alia*, that NSAs be “available on public and reasonable terms to similarly situated mailers.” The Commission’s current regulations do not require any information of the Postal Service’s notice of agreement to address this requirement, except perhaps the mandate that the Postal Service provide “a description clearly explaining the operative components of the agreement.” Rule 3010.42(b). This Commission mandate addresses only the first half of the statutory requirement — “public and reasonable terms” — but fails to address the second half: which mailers might be considered similarly situated.

The question of similarly situated mailers was an issue in Docket No. MC2012-14/R2012-8, the Valassis NSA docket. The Commission was not satisfied with the information repeatedly presented by the Postal Service’s notice, and finally asked in Notice of Inquiry No. 1 for a discussion of “the meaning of a ‘similarly situated mailer’ under 39 U.S.C. 3622(c)(10) as it relates to the Valassis NSA.” Docket No. MC2012-14/R2012-8, NOI No. 1, question 7.

The adequacy of the Commission’s approach is currently on appeal, but regardless of that appeal, Valpak believes that it would be important for the Postal Service to be required to identify the types of mailers it considers similarly situated to a mailer in a proposed NSA in its initial proposal of the NSA.

C. Require an Explanation from the Postal Service Why a Niche Classification for Similarly Situated Mailers Is Impractical or Inferior to the Proposed NSA.

A further amendment should be made to rule 3010.42 that would require the Postal Service to explain in its proposal why it would be “impracticable to offer” a niche classification that would be available broadly as part of the general tariff schedule. There was a similar requirement under Commission regulations for NSAs prior to PAEA.⁵ Niche classifications address some of the systemic problems identified with NSAs, including the inherent problem of preferences and discrimination (39 U.S.C. § 403(c)) among mailers. If they can be used, they should be used, and the Postal Service should be required to show why they could not be used in lieu of a special NSA deal tailored to one mailer.

Respectfully submitted,

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⁵ Former regulation 39 C.F.R. § 3001.195(a)(1) required: “A written justification for requesting a Negotiated Service Agreement classification as opposed to a more generally applicable form of classification.”